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ECONOMIC AND ENVIRONMENTAL QUESTIONS: INTERNATIONAL COOPERATION IN TAX MATTERS

Seventh meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

Report of the Secretary-General

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INTRODUCTION

1. As requested by the Economic and Social Council in its decision 1994/211, the seventh meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters was held at the Palais des Nations, Geneva, from 11 to 15 December 1995.

2. The Group of Experts stressed the importance of tax issues in view of the globalization of the world economy following the end of the cold war, and emphasized that any discussion of international tax issues must take account of the varying levels of economic development of countries around the world.

3. There was an urgent need for international cooperation to reduce incompatibilities between tax systems so as to promote international trade liberalization, expansion and investment, as well as the transfer of technology. Such cooperation was also necessary to ensure the exchange of information and thus facilitate the implementation of double taxation treaties and enhance compliance with national taxation regimes.

4. The work of the Group of Experts formed part of the continuing efforts of the United Nations and other international organizations to eliminate double taxation, prevent international tax evasion and avoidance, and improve national tax collection performance in order to improve international income allocation and enhance financial resource mobilization for sustainable socio-economic development.

5. Some 21 experts and 23 observers participated at the seventh meeting. The agenda was based on recommendations made at the sixth meeting, as well as on the deliberations and suggestions of the Steering Committee, the successor to the preparatory subgroup.

6. The Steering Committee had met at United Nations Headquarters from 5 to 7 June 1995 and had proposed four areas of special attention: (a) the tax treatment of teachers and students, with reference to the possible deletion of article 14, paragraph 1 (c), and of article 20, paragraph 2, of the United Nations Model Double Taxation Convention between Developed and Developing Countries; (b) the tax treatment of transfer pricing; (c) the tax treatment of financial instruments and derivatives; and (d) the updating of the Model Convention and the Manual for the Negotiations of Bilateral Tax Treaties between Developed and Developing Countries.

7. The Steering Committee had also considered expanding the role of the Group of Experts to include the provision of technical assistance and support in the areas of tax administration, international taxation, transfer pricing and the negotiation of tax treaties. Such assistance would help Member States to minimize national and international tax evasion and avoidance, and would facilitate the resolution of treaty disputes and the negotiation of tax treaties, thus contributing to improving international income allocation and expanded international development.

8. The Group of Experts adopted the following agenda (ST/SG/AC.8/1995/L.1):

1. Opening of the meeting.

2. Remarks by the Director and the Secretary of the Group of Experts.

3. Election of officers.

4. Adoption of the agenda and organization of work.

5. Taxation of special categories: teachers and students.

6. Transfer pricing, in particular as it related to pricing of primary products between related entities, cost-sharing arrangements and the provision of services.

7. Tax treatment of new financial instruments (hybrid instruments).

8. Discussion of the draft revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries and of the Manual for the Negotiation of Bilateral Treaties Between Developed and Developing Countries.

9. Other topics.

10. Arrangements for the eighth meeting.

9. Meeting documentation will be published in part II of the report of the Group of Experts on its seventh meeting.

10. The Ad Hoc Group of Experts on International Cooperation in Tax Matters was accorded its current name by the Economic and Social Council in its resolution 1980/13 of 28 April 1980 to continue the work initiated by the Group of Experts on Tax Treaties between Developed and Developing Countries, which had originally been established by the Council in its resolution 1273 (XLIII) of 4 August 1967.

I. TAXATION OF SPECIAL CATEGORIES: STUDENTS AND TEACHERS

11. The Group of Experts considered three issues: whether article 14, paragraph 1 (c) should be deleted from the Model Convention; whether article 20, paragraph 2 should be deleted; and whether the Model Convention should contain a separate article on the taxation of visiting teachers and researchers.

A. Article 14 (1) (c)

12. The question of whether to delete or retain article 14, paragraph 1 (c) of the Model Convention was considered. That provision allowed remuneration from independent personal services to be taxed at source if it exceeded a fixed amount established in bilateral negotiations, even if the taxpayer had no fixed

base in the source country and regardless of the length of the taxpayer's presence in that country.

13. Issues addressed by the Group of Experts included the importance of the article for all countries, especially developing countries, which assessed tax primarily or exclusively on the basis of source of income, and the effect of inflation on any stipulated monetary threshold over time. Other considerations were the short time-frames within which some services were performed and the need to properly recognize any preparatory costs incurred in the country of residency.

14. It was also noted that during the 15 years that the Model Convention had been in use, the provision had not been included in the majority of treaties concluded between developed and developing countries.

15. After discussion, it was concluded that a majority of the Group of Experts but not yet a consensus favoured deletion of article 14, paragraph 1 (c).

B. Article 20 (2)

16. The Group of Experts noted that the article's intention was to extend all tax benefits allowed to residents to visiting students. It was noted that practical attainment of parity between members of that class of taxpayers could be elusive in countries in which resident students were taxable on their global income from all sources while visiting students were taxable only on income from sources in the visited country.

17. A possible contradiction was noted in article 24, paragraph 4 (second sentence), which stated that a country was not required to grant non-residents any personal allowances or other reliefs on account of civil status or family responsibilities that might be allowed to resident taxpayers.

18. After deliberation, it was concluded that a majority of the Group of Experts but not yet a consensus favoured deletion of article 20, paragraph 2.

C. Article for teachers

19. The Group of Experts considered the inclusion of an article dealing with visiting teachers in the Model Convention.

20. In the current Model Convention, visiting teachers were subject to article 14 if the teaching services were performed in an independent capacity; to article 15 if the services were dependent; or to article 19 if the remuneration was paid by a Contracting State. Many treaties had an additional article or paragraph that dealt specifically with teachers and sometimes researchers, which typically exempted them from taxation in the source country if their stay did not exceed a prescribed length. It was emphasized that the issue was significant for many countries, especially the developing countries.

21. It was noted that articles 14 and 15 did not commonly exempt a visiting teacher's compensation from taxation at source because they generally allowed source taxation of services performers who were present in the host country for more than 183 days and many teaching assignments exceeded that amount of time.

22. It was stated that the Model Convention should only include provisions on which a broad consensus existed and in that case no such consensus had yet emerged. Such an article could establish a precedent that might give rise to claims for treaty exemptions for many other meritorious groups. It was noted that the purpose of income tax treaties was to promote interchanges of all sorts and - notwithstanding the importance of educational and cultural services - not to introduce specific provisions for particular groups or activities.

23. It was generally agreed that the otherwise applicable articles of the Model Convention provided adequate protection against double taxation; if any host country wished to provide an incentive to visiting teachers, it could do so unilaterally.

24. It was agreed that any article on teachers, if included in the Model Convention, should not have the effect of exempting a teacher from tax both in the home country and in the country visited.

25. One possible compromise emerged: instead of amending the Model Convention to include an article on visiting teachers, an addition could be made to the Commentary providing advice for bilateral negotiations on the subject, as had been done for similar treaties.

26. Accordingly, the Group of Experts appointed a drafting committee, which formulated language for inclusion in the commentary on the Model Convention.

II. TRANSFER PRICING

27. The subject of transfer pricing could be characterized as one of the most important and challenging issues that had arisen from the globalization of commercial activities. It was noted that the Organisation for Economic Cooperation and Development (OECD) had considered the matter at length over several years, and that the Steering Committee, at its June 1995 meeting, had identified five issues for consideration by the Group of Experts, namely:

(a) Administrative capabilities for dealing with transfer pricing issues;

(b) Assistance by developed countries to developing countries in the area of transfer pricing enforcement;

(c) Treatment of finished goods versus primary goods;

(d) Exchange of information;

(e) Mechanisms for correlative adjustments.

28. The Steering Committee had agreed that consideration of transfer pricing issues by the Group of Experts was important for ensuring that the interests of both developing and developed countries were adequately represented in any international consensus on those issues.

29. Reference was made to OECD reviews of transfer pricing issues, which had begun with a report issued in 1979 and had culminated most recently with the publication in 1995 of Transfer Pricing Guidelines. OECD intended to supplement the Guidelines with additional chapters on, among other things, transfer pricing of intangibles and cost-sharing arrangements.

30. OECD was also studying the feasibility of arbitrating transfer pricing disputes. In formulating the Guidelines, OECD had considered comments from developing countries and planned further meetings with developing countries on the subject. In addition, some OECD members that were actively participating in the transfer pricing project were doing so out of a great concern for preserving their tax bases as source countries and as producers of primary products.

31. At the June 1995 meeting of the Steering Committee, reservations had been expressed about the effects of cost-sharing arrangements in developing countries. Often, it had been argued, new technology was not transferred to developing countries until decades after it had been conceived, and the effect of cost-sharing research and development expenses could be to allocate portions of such expenses to developing countries even though any benefits to those countries from such research and development were very remote over time. Under a proper application of cost sharing, expenses should be allocated to a particular country only to an extent that appropriately reflected the benefits of such expenditures for that country.

32. It was considered that transfer pricing was not an issue of contention between developed and developing countries; the basic problem of enforcing the arm's length principle was faced by all countries. Moreover, many developing countries were highly developed in certain aspects of their economies, such as manufacturing for export, and thus encountered the same difficulties in that area as the industrialized countries.

33. It was noted that there was a need to study the connections between customs valuations and transfer pricing for income tax purposes. Conflict could arise between a customs agency that sought to maximize the value of goods as they entered the country and a tax administration that sought to minimize the transfer price by which goods were imported.

34. It was proposed that the Group of Experts work closely with OECD on transfer pricing, duly noting any points of departure from the OECD conclusions and identifying them as areas in which further consideration and guidance was needed to assist Member States using the Model Convention.

35. The nomination of an international body to deal with transfer pricing was discussed. Reference was made to a report prepared by a consultant to the Department for Development Support and Management Services of the United Nations Secretariat, entitled "Transfer pricing and taxation of international income in developing countries" (ST/SG/AC.8/1995/L.8). The report had proposed that an

international organization undertake the following: (a) develop a uniform set of transfer pricing principles to be adopted by all countries participating in the initiative; (b) formulate regulations and forms so that a firm doing business in two or more participating countries could file one form allocating its income among the different countries; and (c) assemble a group of experts such as retired tax professionals, to provide advice to countries and assist in the resolution of disputes.

36. Although the above-mentioned proposal was supported in principle, it was felt that the issues of tax administration and taxpayer education as well as the lack of audit and other resources required to enforce transfer pricing rules also needed to be addressed by many countries. An international body of the sort proposed, it was suggested, could help countries to deal with such problems.

37. Limitations to the proposal were also identified. The willingness of countries to accede to a common set of transfer pricing principles, rules, or regulations could be constrained by any derogation from their sovereignty that would be imposed. Moreover, acceptance of the idea might not be politically feasible at any time in the foreseeable future because it represented a new paradigm. The experience of the European Union in its development of a multilateral convention on the arbitration of tax disputes relating to transfer pricing, which had become effective as from the beginning of 1995 more than 20 years after work on it began, was cited as evidence of the slowness with which new initiatives were accepted in that context.

38. A more practical approach was considered, namely, the inclusion of arbitration clauses in bilateral treaties for the resolution of transfer pricing disputes between countries. It was noted that that concept would provide an ongoing resolution mechanism rather than requiring a separate arbitration panel for each case.

39. It was stated that the needs of many developing countries in that area went beyond dispute resolution, and that if a country lacked the resources required to develop transfer pricing cases there would be no disputes to resolve. It was more important for an international body to provide technical assistance and training to the tax administrations of countries without expertise and resources in that area. The primary needs of developing countries were to obtain information relevant to transfer prices reported by companies, as well as to develop information-processing capabilities.

40. It was agreed that a drafting committee be appointed to develop proposals on activities to be undertaken by the Group of Experts in the area of transfer pricing. The recommendations of that drafting committee were subsequently reported to the Group of Experts with recommendations.

III. NEW FINANCIAL INSTRUMENTS

41. The Group of Experts was briefed on the complex technical area of new financial instruments by the Special Adviser to the Secretary. It was noted that those instruments could be divided into three groups: debt instruments,

including bonds issued at a discount; derivatives; and hybrid instruments, in which derivatives were embedded in debt instruments.

42. Derivatives, in turn, came in three principal varieties: options; forwards, including exchanged-traded futures and privately negotiated forward contracts; and notional principal contracts. Of those, the most recent in origin was the notional principal contract, which included swaps of various kinds, such as interest rate swaps, currency swaps and equity swaps, and option-like devices known as caps, floors and collars.

43. Derivatives and other new financial instruments presented a host of tax problems. When a debt instrument was issued at a discount, interest on the instrument consisted, in whole or in part, of accrual of the discount, but if interest income was taxed only when paid, such as under a withholding tax scheme for interest paid to foreign persons, the use of discount instead of interest-bearing bonds tended to defeat or at least defer the tax.

44. In addition, because derivatives could be combined in ways that mimicked the economic behaviour of non-derivative instruments (for example, a bond plus a package of options could have the same economic consequences as ownership of a share of stock) derivatives could be used by taxpayers to avoid unwanted tax consequences. In other words, if the tax rules for various types of investment vehicles were not completely consistent, taxpayers could use derivatives to choose the tax treatment that they most desired; moreover, achieving complete consistency was difficult if not impossible because various instruments differed in ways that were traditionally considered highly relevant to taxation, such as the predictable returns of a debt instrument versus the unpredictable returns on most equity investments.

45. On the other hand, tax rules could upset economically valuable uses of derivatives. Derivatives were commonly used to hedge business and financial risks (for example, an interest rate swap might be used to transfer away the interest-rate risk under a borrowing obtained at a variable rate), and a perfect hedge before taxes might be a highly imperfect hedge after taxes if the taxation of the hedge was not coordinated with the taxation of the transaction or investment giving rise to the risk being hedged. Miscoordination could result if the hedge and the hedged activity or investment were subject to differing characterizations, such as ordinary income versus capital gain, or if there were timing discrepancies, such as one being taxed on a realization basis while the other was taxed on an accrual basis.

46. Derivatives and other new financial instruments also raised many issues under treaties. It was unclear in many instances whether income from such instruments was subject to the article on business profits, capital gains or the article on other income. The answers to such questions often depended on the nature of the particular instrument, the characterization of the instrument under the national law of the taxing country and unresolved questions of treaty interpretation.

47. It was agreed that before the Group of Experts could enter into any meaningful dialogue on such technically complex issues, there needed to be a general enhancement of the level of understanding of such mechanisms and their

implications for taxation. The Group of Experts noted that consideration of that important issue was in its introductory stages and further analysis would need to be made.

IV. MONITORING THE IMPACT OF THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION ON BILATERAL NEGOTIATIONS AND DISCUSSION OF A DRAFT REVISION OF THAT CONVENTION

48. The United Nations Model Convention, which was adopted in 1979, differed from the 1992 OECD Model Double Taxation Convention on Income and on Capital in that some provisions in certain of its articles took into account the conditions of developing countries. The monitoring of the impact of the United Nations Model Convention was an undertaking in keeping with the terms of reference of the Group of Experts, one of the provisions of which required a continuing examination of the Model Convention and consideration of the experience of countries in bilateral applications of the Model Convention. The objectives of the continuing review were to identify particular problems encountered in the course of working with the model and possible solutions; clarify the meaning of phrases shown to be imprecise; illuminate the different views that might be taken of particular concepts or terms; and indicate possible compromises.

49. The Group of Experts discussed the Model Convention under two headings, namely, the articles of the convention itself and the related Manual mentioned above.

50. Before considering the revision of the Model Convention, a report prepared by a consultant to the Department for Development Support and Management Services, entitled "Trends in recently negotiated tax treaties between developed and developing countries" (ST/SG/AC.8/1995/L.9) was considered. The document, which covered more than 50 treaties concluded during the last 10 years, compared each treaty with both the United Nations Model Convention and the OECD Model Convention, and identified the trends in treaty formulation arising from that comparison. The study had been initiated as a result of decisions made by the Steering Committee at its June 1995 meeting.

51. Further reference was made to the United Nations Tax Treaty Series, which published Member States' bilateral treaties. The participants agreed to provide the United Nations Secretariat with copies of their newly concluded bilateral tax conventions in all of the languages in which they had been ratified in order to fully support the Series.

52. Participants were also referred to the database maintained by the International Bureau For Fiscal Documentation, which contained the text of 1,300 bilateral tax conventions, including practically all conventions in existence.

53. It was agreed that information exchanges between the Secretariat and the database would be facilitated in order to conduct a comprehensive survey of tax treaties between developed and developing countries that incorporated the unique provisions of the United Nations Model Convention.

54. It was noted that the environment in which tax treaties were negotiated was dynamic and constantly changing. A revised Model Convention would be a major contribution supporting the negotiation process because the Model Convention was widely used in treaty negotiations.

55. The Group of Experts then considered a draft revised United Nations Model Double Taxation Convention between Developed and Developing Countries (ST/SG/AC.8/1995/WP.9), which took into account changes made to the 1992 OECD Model Convention as well as provisions commonly appearing in treaties concluded between developing and developed countries.

56. It was noted that the changes made to 1992 OECD Model Convention had been the result of extensive deliberations over many years with broad participation, suggesting that the Group of Experts might likewise expect to reach agreement on the revision of the United Nations Convention only after a reasonable period of consultation.

57. Taking that constraint into consideration, it was proposed that the Group of Experts focus on particular issues by selecting topics of greatest interest in negotiations of treaties between developed and developing countries.

58. In addition, it was agreed that all United Nations Member States would be called upon to submit proposals outlining issues for consideration by the Group of Experts.

59. It was agreed that responsibility for the organization of that work would be coordinated by a Steering Committee that would report on progress to future meetings of the Group of Experts. Nomination of members of the Group of Experts to serve on the Steering Committee would be sought and their appointment confirmed by the Secretariat. The Group of Experts would be advised when the Steering Committee had been formally convened.

60. It was proposed that the Steering Committee meet at least once, perhaps twice, before the eighth meeting of the Group of Experts, and that the Group of Experts provide guidance for the Steering Committee's work at that meeting.

61. Consideration was given to whether the goal of the revision should be a new United Nations Model Convention or the issuance of supplements to the existing Model Convention as agreement was reached on each particular change.

62. The consensus of the Group of Experts was that no decision should then be made on that issue, and that the Steering Committee should consider both options in making its recommendations.

63. Participants identified issues that might be considered by the Steering Committee in its early deliberations, including the articles on interest, dividends, royalties and capital gains; the force of attraction principle in article 7, paragraph 1; article 7, paragraph 3 (Allocation of expenses to permanent establishments); tax sparing credit; limitation of benefits provisions; transfer pricing; and teachers.

64. In order to support the ongoing process of treaty negotiations and in view of the lengthy process involved in concluding any revisions, the Group of Experts indicated that it would be useful meanwhile to have the 1980 United Nations Model Convention reprinted. The Secretariat was requested to facilitate the reprinting of a sufficient number of copies of the Model Convention.

V. EXPANSION OF THE ROLE OF THE GROUP OF EXPERTS RELATING TO TECHNICAL ASSISTANCE IN INTERNATIONAL TAXATION

65. Consideration was given to expanding the role of the Group of Experts to include providing technical assistance in the area of international taxation.

66. Although primarily a policy-making body, the Group of Experts had been requested to provide technical assistance in the field of tax administration, international taxation and the negotiation of tax treaties. Such assistance would provide for capacity-building in developing countries, enabling them to more effectively negotiate tax treaties, generate additional revenues for socio-economic growth and facilitate the resolution of any treaty disputes.

67. The Department for Development Support and Management Services and other organizations offered such technical assistance, including training seminars, and any efforts of the Group of Experts in that area should be coordinated with those other efforts. Pursuant to requests made at the sixth meeting of the Group of Experts, the Secretariat had served as a clearing-house for the exchange of information on tax conventions, and had stood ready to provide assistance in international taxation matters.

68. The Group of Experts noted the document entitled "Proposal concerning the possible expansion of the role of the Ad Hoc Group of Experts on International Cooperation in Tax Matters" (ST/SG/AC.8/1995/WP.4), which had been developed by the Secretariat in response to a request made by the Steering Committee at its June 1995 session.

69. The proposal called for five annual interregional workshops to be convened, commencing in 1997, to promote worldwide development of expertise in international taxation, with a special emphasis on the prevention of tax evasion and avoidance, and the prevention of double taxation. The workshops could be held at United Nations Headquarters and in Africa, Asia, Europe and Latin America, and it had been proposed that each be attended by up to 35 participants from all regions, and that Governments be invited to send additional participants at their own expense.

70. Under the proposals the workshops, which could be organized under the auspices of the Group of Experts, would consist of lectures, training and practical guidance based on case studies. They would be conducted by members of the Group of Experts, together with international tax experts from the International Monetary Fund, OECD, regional and subregional fiscal organizations, and universities with international tax programmes, depending on the availability of such experts.

71. Each workshop would also provide a forum for the exchange of experience among tax administrators from various regions. Workshop graduates would be expected to act as trainers, passing along knowledge acquired at the workshops to their colleagues in the tax administrations of their respective countries.

72. The Group of Experts noted the need for coordination of the proposed technical assistance programme with the efforts of other organizations.

VI. EIGHTH MEETING OF THE GROUP OF EXPERTS

73. The Group of Experts agreed on the following provisional agenda for its eighth meeting:

1. Opening of the meeting.
2. Remarks by the Director and the Secretary of the Group of Experts.
3. Election of officers.
4. Adoption of the agenda and organization of work.
5. Revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries.
6. Financial instruments.
7. Transfer pricing.
8. Tax havens, including exchanges of information.
9. Other matters.
10. Arrangements for the ninth meeting of the Group of Experts.

74. The Group of Experts tentatively scheduled its eighth meeting for 15 to 19 December 1997.